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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., ET AL.,

Petitioners,

v.

HOWARD GREENWALD, ET AL.,

Respondents.

On Petition for Writ of Certiorari To The United States Court of Appeals For the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF THE PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE OF THE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONERS

In accordance with Rule 37.2 of the Supreme Court Rules, the American Bankers Association respectfully moves for leave to file a brief as amicus curiae in support of the Petitioners. The Petitioners have consented to this filing, and their written consent is filed with this brief. Counsel for the Respondents have declined to consent.

The American Bankers Association is the principal national trade association of the commercial banking industry in the United States. As a representative of the industry, the Association has a distinct interest in ensuring that our members are not subject to the burden and expense encountered when defending against unfounded claims of securities fraud.

The decision of the Ninth Circuit in the case below establishes a pleading standard in securities fraud cases which will simply encourage the continued filing of such debilitating lawsuits. By failing to adhere to the standards of pleading fraud under the Federal Rules, the holding below will allow the resources of both the banking industry and the judiciary to be squandered.

Consequently, the Ninth Circuit's decision raises issues of great importance to banking, and we respectfully suggest that the Court might benefit from a brief that discusses those issues from a perspective broader than that of the immediate parties to the case.

WHEREFORE, the American Bankers Association moves that leave be granted to file the attached brief as amicus curiae.

Respectfuliy submitted,

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QUESTION PRESENTED

Did the Ninth Circuit err in concluding, contrary to well-reasoned decisions from other circuits, that a complaint:

a. satisfies the "misrepresentation" element of a Rule 10b-5 claim by alleging that a bank's extraordinary increase in its loan loss reserve for one period implied that the reserve for a previous period was fraudulently understated?

b. satisfies the "scienter" element of a Rule 10b-5 claim by alleging that corporate defendants were motivated to perpetrate a fraud solely to maximize their compensation and job security?

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BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF THE PETITIONERS

INTEREST OF THE AMICI CURIAE

The American Bankers Association ("ABA") files this brief as amicus curiae in support of the Petitioners. The ABA is the principal national trade association of the commercial banking industry in the United States. It has members in each of the fifty states and the District of

Columbia and represents banks of all types (national and state chartered banks) and sizes (money center, regional and community banks). ABA members hold approximately ninety percent of all domestic assets in commercial banks located in the United States.

The matter decided by the court below involves the pleading sufficiency of a complaint of securities fraud under Securities and Exchange Commission Rule 10b-5. This is a legal issue of the utmost concern not only to the banking industry, but to business in general. Of particular interest to the ABA and its members is the treatment of the accounting practice known as reserving against loan losses.

As this Court is no doubt aware, the late 1980's and early 1990's was a time when certain segments of the United States economy suffered through a lingering recession, particularly with respect to real estate. As lenders determine that it is unlikely loans will be repaid and that the declining value of collateral will make the lender undersecured, loan loss reserves are increased. When reserves are increased suddenly and substantially, it is as if the bank spent or lost that money at the time the reserves are set aside. That has an effect upon the net income of the bank and, ultimately, upon the market value of bank stock. It is easy, with benefit of hindsight, to claim that "adequate" loan loss reserves should have been established earlier so as to present a more "accurate" picture of the true value of a bank's stock. In fact, during the most recent economic downturn, numerous shareholder suits were filed against banks containing allegations of securities fraud because of losses in the banks' loan portfolio. *See*, Sands, *Lending Practices Land Banks in Court*, Washington Times, April 20, 1990, at C1.

Because of the expense of such lawsuits and because it is impossible to run a bank if honest and reasonable business judgments are made into guarantees of positive investment results, it is extremely important that courts be able to dismiss suits which fail to state clearly the "fraudulent" activity being charged.

REASONS FOR GRANTING THE WRIT

It is critical for the Court to review the decision of the Ninth Circuit for several reasons. First, as noted in the bank's brief, the holding below conflicts with decisions by other United States Courts of Appeal which have considered the issue. Second, if the Ninth Circuit's decision stands, unmeritorious suits will continue to be filed with the inevitable waste of both judicial and private sector resources.

I. THE PLEADING STANDARDS FOR SECURITIES FRAUD ADOPTED BY THE NINTH CIRCUIT ARE INSUFFICIENT FOR CLAIMS BASED ON INADEQUATE LOAN LOSS RESERVES AND CONFLICT WITH DECISIONS IN OTHER CIRCUITS.

A. Loan Loss Reserves

One of the key holdings by the court below was that the Respondents' complaint adequately states a cause of action under the Securities Exchange Act of 1934. Among the Respondents' allegations is that Wells Fargo deliberately understated its loan loss reserves and, therefore, committed securities fraud. *In re Wells Fargo Securities Litigation*, 12 F.3d 922, 925 (9th Cir. 1993). This presents an important question on which this Court should provide guidance: What is the standard for pleading securities fraud in the context of a claim of inadequate loan loss reserves?

The allowance for loan losses appears on a balance sheet as a deduction from the value of a loan portfolio. Commentators have recognized several functions which could be served by the reserve. These include an experience function, catastrophe function, and a valuation function. Golembe Associates, *The Adequacy of Bad Debt Reserves for Banks - A Preliminary Study* at 2 (1972). *See, also,* Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Concepts No. 6 - Elements of Financial Statements* at 9134 (1985) (hereinafter CON No. 6). The experience function assumes that the loan loss reserve is intended to absorb losses which can be expected to occur in a single average year and is achieved by averaging out actual loss experience from past years. It is viewed as producing "the lowest benchmark" for the loss reserve. T. Hardy, *The Allowance for Loan Losses: Fact or Fiction?* at 8 (June, 1986) (unpublished thesis available at the American Bankers Association library).

In contrast to the experience function, a loan loss reserve based on the catastrophe function assumes that the allowance should enable the lender to withstand loan losses which would occur under unforeseen economic crises such as a depression. *Id.* This probably represents the upper limit on the amount of the reserve but would "artificially inflate the allowance amount and make it difficult for the public as well as bank management to evaluate the problems inherent in a loan portfolio." *Id.* at 9.

Somewhere between these two extremes is the notion of the loan loss reserve serving a valuation function. For example, CON No. 6, ¶ 34, states that some accounts on a balance sheet serve as valuation accounts (i.e., a separate item which reduces or increases the carrying amount of an asset). In this context the loan loss reserve would "represent

a measure of all losses expected in a given loan portfolio through its liquidation in the ordinary course of business." T. Hardy, *supra*, at 10.

The guidance from the accounting profession makes it clear that the loan loss reserve is to serve a valuation function for financial reporting purposes. "The amount of [the loss reserve] can be considered reasonable when the allowance for loan losses . . . is considered by management to be adequate to cover estimated losses inherent in the loan portfolio." American Institute of Certified Public Accountants - Banking Committee, *Audits of Banks* at 61 (2d. ed. 1983).

As to <u>when</u> such losses need to be identified, the accounting standards recognize the factors involved in this undertaking. Paragraph 8 of FASB Statement No. 5: *Accounting for Contingencies* (FASB No. 5), for example, requires that the loss be probable and reasonably estimable before it is accrued. *See*, Financial Accounting Standards Board, *Accounting Standards - Current Text - General Standards* at § C59.105. ("Losses from uncollectible receivables [*e.g.*, principal and interest on loans] shall be accrued when both conditions [probable and reasonably estimable] are met.") The banking regulatory guidance is similar. "[I]t is not the examiner's responsibility to initially ascertain the amount of allowance, but rather to determine that management has exercised its responsibility to use *reasonable* judgment based upon reliable information to arrive at an appropriate allowance." Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* § 217.1 (1984) (emphasis added).

B. Conflicts in the Circuits

As noted in the bank's Petition for Writ of Certiorari, this issue is one which has confronted a number of United States Courts of Appeal, and these courts continue to struggle in their attempts to hold plaintiffs' complaints to the strictures of the Federal Rules of Civil Procedure. What is readily evident from the discussion above is the subjective process for arriving at the "correct" amount of loan loss reserves. Unlike such objective entries on a financial statement as inventory and sales, the amount stated for loss reserves is nothing more than an educated prediction of future events. Robert Morris Associates, *Managing the Allowance for Loan and Lease Losses State of the Art* at 11 (1988). This prediction will likely be based on a system which sets forth a particular method of evaluation (*e.g.*, frequency of review, documentation, minimum allowable allowance, identification of problem loans, allocation of loss for specific loans, etc.) but the decision ultimately remains a guess. *Id.* at 55-60.

As events play themselves out, the correctness of the loan loss reserve calculation can easily be evaluated. From today's standpoint, for example, it has become evident that some financial institutions failed to anticipate the difficulty which would be suffered by certain regions and within certain industries. But miscalculations of the loss reserve, even by a significant amount, do not necessarily represent fraudulent acts by the lending institution. With the improvement in the economy and bank profitability, the pendulum is now beginning to swing. Banks have been criticized for maintaining reserves at *too high* a level and thus *understating* earnings. David Siegel and Bill Atkinson, *Now the Worry is that Reserves Are Too High*, Am. Banker, July 13, 1993, p. 1 col. 1. It is not facetious to suggest that

banks may soon be facing equally groundless fraud claims for over-reserving.

Securities fraud litigation imposes a terrible burden upon both businesses and the judiciary. Shareholder suits, such as the one at issue in this case, typically make broad allegations of fraud based on the inadequacy of loss reserves and are primarily based on 20-20 hindsight. The argument made in such suits is that the bank's financial disclosures state loan loss reserves which later prove to be "inadequate" and, therefore, constitute fraud under section 10(b) of the Securities Act of 1934.

Because of the expense of this type of litigation, it is extremely important for courts to hold plaintiffs to the requirement of Fed. R. Civ. P. 9(b) that fraud allegations be made with "particularity." *Billard v. Rockwell International Corp.*, 683 F.2d 51 (2d Cir. 1985) (Rule 9(b) will be strictly construed to minimize strike suits). *See, also*, William C. Baskin III, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 Yale L.J. 1591, 1594 (1990)(Use of the pleading standard of Rule 9(b) can reduce the "economic incentives facing a professional plaintiff's attorney . . . for the initiation of [§ 10(b)] actions.") In this case, for example, it is not an overwhelming burden to require the plaintiffs to identify specifically in what respect the loan loss reserves were false or misleading at the time the estimates were made. "[M]ere conclusory allegations of fraud are insufficient, statements of the time, place and *nature* of the alleged fraudulent activities are sufficient." *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987) (emphasis added). *See, DiLeo v, Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990) (plaintiffs' complaint that bank's failure to increase reserves constituted fraud inadequate under Fed. R. Civ. P. 9(b) because circumstances of the

fraud "the who, what, when, where and how" not specified). As the First Circuit noted in *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), "We have been especially rigorous in demanding such factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement....'" *Id.* at 878.

Concerns over potential misuse of liberal pleading standards under the Federal Rules are particularly acute in class action litigation challenging a bank's loan loss reserve. As the Court has recognized, class action securities litigation of all types "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). That danger is certainly present in litigation over a bank's alleged understatement of the loan loss reserve. By definition, every financial institution's provision for loan loss reserves changes over time. Since change is the rule, not the exception, plaintiffs invariably allege that, for some time before the reserve increase, defendants knew or should have known that then-existing reserves were inadequate. *Cf. Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991). If broadbrush allegations such as these suffice to state a claim under Rule 9(b), defendants will have little protection from the burden and expense of litigation.

II. IMPORTANCE OF THE ISSUE

To be sure, the phenomenon described is not isolated to the banking industry. Commentators have recognized that private enforcement of the federal securities laws is "big business" with private class action counsel filing "hundreds

of lawsuits alleging federal securities law violations" and plaintiffs' counsel reaping "hundreds of millions of dollars a year. . . ." Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 961, 971-72 (1994) (noting that during the fiscal year ending June 30, 1992, 642 securities and commodities fraud suits were pending in the federal district courts, *see*, n.28).

Every year, many institutions settle unmeritorious claims to avoid the cost and risk of defense. *See* Brent Bowers, Udayan Gupta, *Shareholder Suits Beset More Small Companies*, Wall St. J., March 9, 1994, at B1 (reporting that class action cash settlements to shareholders nearly quintupled to $1.55 billion between 1988 and 1992). Caution in allowing plaintiffs to proceed with securities claims is necessary because

> even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Blue Chip Stamps, 421 U.S. at 740. *Accord Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985).

The failure to impose a strict pleading standard in this case sends the wrong signal to the plaintiff bar and

encourages the continued filing of unfounded securities fraud claims.

CONCLUSION

The amicus asks this Court to grant the petition and overturn the decision of the court below. The ruling does not enforce the correct standards for pleading securities fraud. As a result, plaintiffs are encouraged to pursue often groundless allegations and engage in discovery "fishing expeditions." If this Court fails to overturn the Ninth Circuit's ruling, banks and other commercial enterprises are certain to face unfounded charges of fraud every time economic reversals beyond the control of even the most prudent banker cause investors to lose money.

Respectfully submitted,

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